



BILLING CODE: 8070-01-P

FEDERAL HOUSING FINANCE AGENCY

[No. 2012-N-14]

Advisory Bulletin on Collateralization of Advances and Other Credit Products

Provided by Federal Home Loan Banks to Insurance Company Members

AGENCY: Federal Housing Finance Agency.

ACTION: Notice with request for comments.

SUMMARY: The Federal Housing Finance Agency (FHFA) is requesting comments on a proposed Advisory Bulletin which would set forth standards to guide agency staff in its supervision of secured lending to insurance company members by the Federal Home Loan Banks (Banks).

DATES: Written comments must be received on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN FEDERAL REGISTER].

ADDRESSES: You may submit your comments, identified by FHFA notice number 2012-N-14, by any of the following methods:

- **E-mail:** Comments to Alfred M. Pollard, General Counsel may be sent by e-mail to RegComments@fhfa.gov. Please include “2012-N-14” in the subject line of the message.
- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments. If you submit your comment to the [Federal eRulemaking](#)

Portal, please also send it by e-mail to FHFA at RegComments@fhfa.gov to ensure timely receipt by FHFA. Please include “2012-N-14” in the subject line of the message.

- U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service: The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/2012-N-14, Federal Housing Finance Agency, Eighth Floor, 400 7th Street, SW., Washington, DC 20024.
- Hand Delivered/Courier: The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/2012-N-14, Federal Housing Finance Agency, Eighth Floor, 400 7th Street, SW., Washington, DC 20024. The package should be logged at the FHFA Guard Desk, First Floor, on business days between 9 a.m. and 5 p.m.

FOR FURTHER INFORMATION CONTACT: Neil Crowley, Deputy General Counsel, Office of General Counsel, Neil.Crowley@fhfa.gov, (202) 649-3055; Joseph A. McKenzie, Associate Director, Division of Bank Regulation, Bank Analysis Branch, Joseph.McKenzie@fhfa.gov, (202) 649-3270; or Thomas Doolittle, Senior Financial Analyst, Division of Bank Regulation, Bank Analysis Branch, Thomas.Doolittle@fhfa.gov, (202) 649-3273 (these are not toll-free numbers), Federal Housing Finance Agency, 400 7th Street, SW., Washington, DC 20024. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

SUPPLEMENTARY INFORMATION:

I. Comments

FHFA invites comments on all aspects of this Notice and the attached Advisory Bulletin. Copies of all comments will be posted without change, including any personal

information you provide, such as your name, and address (mailing or email), and telephone numbers, on FHFA's Internet Web site at <http://www.fhfa.gov>. In addition, copies of all comments received will be available for examination by the public on business days between the hours of 10 a.m. and 3 p.m. at the Federal Housing Finance Agency, Eighth Floor, 400 7th Street, SW., Washington, DC 20024. To make an appointment to inspect comments, please call the Office of General Counsel at (202) 649-3084.

II. Background

The Federal Home Loan Bank System consists of twelve regional Banks and the Office of Finance (OF). The Banks are instrumentalities of the United States organized under the Federal Home Loan Bank Act (Bank Act).¹ The Banks are cooperatives; only an institution that is a member of a Bank may purchase its capital stock, and only members or certain eligible non-member housing associates (such as state housing finance agencies) may obtain access to secured loans, known as advances, or other products provided by a Bank.² Each Bank is managed by its own board of directors and serves the public interest by enhancing the availability of residential mortgage and community lending credit through its member institutions.³ Generally, any federally insured depository institution (i.e., a commercial bank, thrift, or credit union) or state-regulated insurance company, or any entity certified as a Community Development Financial Institution (CDFI) by the United States Department of Treasury, may become a

¹ See 12 U.S.C. 1423, 1432(a).

² See 12 U.S.C. 1426(a)(4), 1430(a), 1430b.

³ See 12 U.S.C. 1427.

member of a Bank if it satisfies certain criteria and purchases a specified amount of the Bank's capital stock.⁴

Section 10(a) of the Bank Act authorizes each Bank to make secured advances to its members, each of which must be fully secured by certain types of eligible collateral enumerated in the statute.⁵ Part 1266 of FHFA's regulations implements and expands upon the statutory requirements pertaining to Bank advances by addressing, among other things: the types and amounts of collateral that a Bank may or must accept when making advances; the priority of Bank claims to such collateral in relation to other creditors; and requirements regarding the valuation and verification of the existence of pledged collateral.⁶

FHFA is an independent agency of the Federal government that is responsible for the supervision and oversight of the Banks, as well as Fannie Mae and Freddie Mac. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act) invests the Director of FHFA with general regulatory authority over those regulated entities and charges him with ensuring that they operate in a safe and sound manner, comply with applicable laws, and carry out their respective policy missions.⁷ The Director is authorized to exercise whatever incidental powers are

⁴ See 12 U.S.C. 1424; 12 CFR part 1263.

⁵ Section 10(a)(3) of the Bank Act enumerates five categories of collateral that are eligible to secure Bank advances: (1) current whole first mortgage loans on improved residential property and securities representing a whole interest in such mortgages; (2) securities that are issued, guaranteed, or insured by the United States Government, or any agency thereof; (3) deposits of a Bank; (4) other real-estate related collateral acceptable to the Bank if it has a readily ascertainable value and the Bank can perfect its security interest in the collateral; and (5) (for certain smaller insured depository institutions) secured loans for small business, agriculture, or community development activities or securities representing a whole interest in such secured loans. See 12 U.S.C. 1430(a)(3).

⁶ See 12 CFR part 1266.

⁷ See 12 U.S.C. 4511(b); 12 U.S.C. 4513(a).

necessary or appropriate to fulfill his duties and responsibilities in overseeing the regulated entities, and to issue any regulations, guidelines or orders as are necessary to carry out his duties.⁸ Advisory Bulletins are documents through which the agency provides guidance to its regulated entities regarding particular supervisory issues. Although Advisory Bulletins do not have the force of a regulation or an order, they reflect the position of FHFA staff on the particular issues addressed and are followed by FHFA staff in carrying out the agency's supervisory responsibilities.

III. The Advisory Bulletin on Insurance Company Collateral

Lending to insurance companies exposes the Banks to a number of risks that are not associated with advances to their insured depository institution members. In large part, these risks arise from the fact that, unlike the Banks' commercial bank, thrift and credit union members, insurance companies are regulated at the state level. In dealing with its insurance company members, each Bank must understand multiple statutory and regulatory regimes and must assess how its interests may be affected by the variations between those regimes. This is made more difficult by the fact that there is little precedent to indicate how the insurance commissioner in any given state would deal with repayment of the member's outstanding advances or with the Bank's security interest in advances collateral in the event of a failure of an insurance company member. In some states a Bank might be required to liquidate collateral in order to obtain repayment of its advances to a failed insurance company, which introduces additional uncertainties about its ability to be made whole.

⁸ See 12 U.S.C. 4513(a)(2), 4526(a).

In addition, the financial statements of insurance companies are based upon statutory accounting principles that are specific to insurance companies, as opposed to the generally accepted accounting principles in the United States on which the financials of most other domestic companies and all federally insured depository institutions are based. While the statutory accounting principles adopted by each state are similar, required reporting practices and reporting frequencies, as well as data definitions and data formats may be quite different from state to state.

Over the last several years, lending to insurance company members has come to represent an increasingly larger portion of the Banks' overall business, and several Banks are actively targeting this member segment. Although insurance companies comprise only about 3.3 percent of total Bank system membership, 12.6 percent of total outstanding advances were to insurance companies as of December 31, 2011—up from 8.7 percent of total advances as of December 31, 2009. This growth, combined with the unique risks to which the Banks are exposed in lending to insurance companies, has led FHFA to focus more intently upon the effective supervision of Banks' credit transactions with their insurance company members.

The attached Advisory Bulletin sets forth a series of considerations that FHFA proposes to use in monitoring these transactions. It focuses upon principles that would be used by agency supervisory staff to assess each Bank's ability to evaluate the financial health of its insurance company members and the quality of their eligible collateral, as well as the extent to which the Bank has a first-priority security interest in that collateral. The risks inherent in lending to insurance companies, which are summarized above, are addressed more thoroughly in the Advisory Bulletin. FHFA seeks comments on all

aspects of the Advisory Bulletin, but is especially interested in receiving comments about the most appropriate method for Banks to obtain “control” of securities collateral and to otherwise obtain a first-priority perfected security interest under the Uniform Commercial Code in any types of collateral pledged by its insurance company members. FHFA is also interested in receiving comments on the use of funding agreements as a means of documenting advances and whether the Banks have confirmed under state law that a Bank would be recognized as a secured creditor with a property interest in the collateral that is pledged to the Bank under a funding agreement. In addition, FHFA welcomes comments on whether it should consider establishing specific and uniform standards for making advances to insurance companies.

IV. Consideration of Differences between the Banks and the Enterprises

Section 1201 of the Housing and Economic Recovery Act of 2008 amended the Safety and Soundness Act to add a new section 1313(f), which requires the Director of FHFA, when promulgating regulations or taking any other formal or informal action of general applicability and future effect relating to the Banks, to consider the differences between the Banks and the Enterprises (Fannie Mae and Freddie Mac) as they relate to: the Banks’ cooperative ownership structure; the mission of providing liquidity to members; the affordable housing and community development mission; their capital structure; and their joint and several liability on consolidated obligations.⁹ The Director also may consider any other differences that are deemed appropriate. In preparing the appended Advisory Bulletin, FHFA considered the differences between the Banks and

⁹ See 12 U.S.C. 4513(f).

the Enterprises as they relate to the above factors, and determined that the guidance set forth therein is appropriate.

Dated: _October 1, 2012_____

Edward J. DeMarco,
Acting Director, Federal Housing Finance Agency.



ADVISORY BULLETIN 2012-AB-xx

September [], 2012

ADVISORY BULLETIN 2012-AB-0X

COLLATERALIZATION OF ADVANCES AND OTHER CREDIT PRODUCTS PROVIDED BY FEDERAL HOME LOAN BANKS TO INSURANCE COMPANY MEMBERS

This Advisory Bulletin (AB-2012- 0X) applies only to the Federal Home Loan Banks.

Introduction and Purpose

Business with insurance companies represents an increasing portion of advances and other credit products for a number of Federal Home Loan Banks (FHLBanks). This bulletin sets forth the principles that the Federal Housing Finance Agency (FHFA) and the FHFA Division of Federal Home Loan Bank Regulation will use to evaluate an FHLBank's lending activities with insurance companies, including collateralization of advances and other credit products provided to insurance company members of the FHLBanks.

Background

Insurance companies provide protection against loss from the risk from identified events occurring or discovered within a specified period. Insurance is a unique product in that the ultimate cost to the insurance company may be unknown until long after revenues, through premiums, are received. Insurance companies must estimate future claims obligations and maintain reserves to meet the obligations that materialize. Typically, insurance company financials reflect estimates of future claims and claim estimates can change unexpectedly due to large, unforeseen events or litigation in certain lines of business.

Statutory Accounting Principles (SAP). Insurance companies file an annual statement, prepared on the basis of Statutory Accounting Principles (SAP), with each state in which they are licensed as well as with the National Association of Insurance Commissioners (NAIC). The annual statements filed with the regulatory authorities are used to monitor the

financial condition of insurance companies in the periods between examinations by state or zone auditors (insurance companies are usually examined once every three to five years).

The NAIC codified SAP in the *Accounting Practices and Procedures Manual*. The insurance laws and regulations of the states require insurance companies domiciled in the states to comply with the guidance provided in that manual except as prescribed or permitted by state law. SAP generally reflects a liquidating rather than going concern basis of accounting. For example, SAP requires that deferred policy acquisition costs be expensed immediately instead of matched against the premiums as they are earned and recognized in income. Accordingly, performance measures calculated using SAP numbers typically appear less favorable than those prepared using GAAP numbers.

Risk Characteristics Associated with Lending to Insurance Companies. FHLBanks typically face risks lending to insurance companies that differ from those associated with lending to federally insured depository institutions. The challenges associated with lending to insurance companies include:

- Potential delay or inability of an FHLBank to commence or continue actions against an insurance company, including liquidating collateral, which could result from a stay imposed by court order or applicable receivership law;
- A preference period (assuming a liquidation) of potentially up to one year in some states;
- Different approaches among states to insurance company supervision and the liquidation or rehabilitation of failed insurance companies;
- Potential ambiguities in insurance laws that could result in an insurance commissioner favoring insured parties over the secured creditors;
- State-by-state variation in SAP and reporting practices, including data definitions, reporting frequencies, and data formats;
- Lack of judicial consideration of how the Bank Act § 10(e) “super lien” would interact with various federal and state laws governing insurance companies; and
- A potentially longer rehabilitation or sale process for a failed insurer, particularly a life insurance company, compared to a failed insured depository.

Guidance

The first line of defense to ensure repayment of an advance or other credit product is the financial health of the member, irrespective of whether the member is a depository institution or an insurance company. The second line of defense is the quality of the collateral and the extent to which the FHLBank has a first-priority security interest in the collateral.

In assessing an FHLBank's lending to insurance companies and collateral position with insurance company members, FHFA and its Division of Federal Home Loan Bank Regulation will evaluate, as appropriate, the following:

- The level of the FHLBank's risk exposure to insurance companies in relation to its capital structure and retained earnings.
- Whether, for each state in which the FHLBank has insurance company members, the FHLBank has recent opinions (or updates of opinions) from competent local counsel addressing the ability of an insurance company to become a member of an FHLBank, to purchase FHLBank stock, to borrow, and to pledge collateral for its borrowings.
- Whether the manner in which the FHLBank proposes to make advances to its insurance company members would be in compliance with applicable state insurance code provisions governing the insurance company's authority to borrow and grant security interests in its assets.
- Whether the FHLBank has an established documented analytical framework and procedures for assessing the creditworthiness of insurance company members at least quarterly using both internal and third-party sources. Whether the FHLBank's procedures differentiate insurance companies that lay off most of their exposure to a single reinsurance company and, if so, whether the FHLBank looks through to the strength of the reinsurance company.
- Whether the FHLBank has experienced staff trained to analyze SAP and GAAP financial statements of insurance companies to assess their financial condition and creditworthiness.
- Whether the FHLBank "controls" pledged securities collateral and any proceeds from the liquidation of the collateral for the purposes of the Uniform Commercial Code (UCC), as enacted by the laws of the appropriate state and has a first priority perfected security interest in that collateral.
- Whether the FHLBank has evaluated and documented the methodology used to establish haircuts for insurance company collateral. In particular, whether the relative risk of failure of an insurer has been taken into account (such as a tiered haircut methodology based upon credit quality). An FHLBank should have objective standards to measure credit quality and should be prepared to take further action, if warranted, to protect its interests in the case of default.
- Whether the FHLBank has documented procedures for obtaining market or fair value estimates of securities collateral on at least a monthly basis. Whether the FHLBank uses more than one pricing service and how it resolves discrepancies among valuation estimates.

- Whether the FHLBank accepts commercial real estate (CRE) loans as collateral and, if so, the extent to which the FHLBank:
 - Obtains a first priority security interest in CRE loan collateral by taking physical possession of the note;
 - Has documented procedures and experienced staff to collect and analyze pertinent information on the quality of the CRE loan collateral on a regular basis;
 - Has documented procedures for obtaining market or fair value estimates of loan collateral regularly and periodically; and
 - Uses a pricing service and benchmarks the service regularly.
- Whether the FHLBank uses market values in excess of book values when assessing collateral and, if so, whether it uses haircuts appropriately to account for price volatility.
- Whether the FHLBank analyzes the potential for market-value depreciation in cases in which holding periods are longer than expected and:
 - Researches and documents the potential for a longer-than-expected holding period; and
 - Considers in its analysis the consequences of a legal stay on the liquidation of collateral of an insurance company.
- Whether the FHLBank has a written collateral liquidation policy for insurance company collateral and has identified resources and developed a contingency plan to liquidate collateral if necessary.
- Whether the FHLBank has established policies related to lending to captive insurance companies that take into account the extent of their insurance activities and whether or not they are affiliated with entities that are subject to regimes of “inspection and regulation” comparable to those of insured depositories or operating insurance companies.
- Whether the FHLBank has been in contact with the state insurance regulator in each state where it has an insurance company member to establish an effective understanding with respect to the prudential operations of the insurance company.
- Whether the FHLBank has established relationships with state insurance regulators to reduce the likelihood of disagreements or misunderstandings regarding the FHLBank’s access to collateral in the event of an insurance company failure or rehabilitation.
- Whether an insurance company in a particular state has the authority to enter into funding agreements and the authority to pledge collateral to support its obligations under the funding agreements such that the FHLBank would be recognized as a secured creditor with a first priority security interest in the collateral and ranks ahead of the claims of policy holders.

Principal Contacts

Joseph A. McKenzie, Associate Director, (202) 649-3270, Joseph.McKenzie@fhfa.gov
Thomas Doolittle, Senior Financial Analyst, (202) 649-3273, Thomas.Doolittle@fhfa.gov

An Advisory Bulletin is a Federal Housing Finance Agency staff document that provides guidance to Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the FHLBanks' Office of Finance regarding particular supervisory issues. Although an Advisory Bulletin does not have the force of a regulation or an order, it does reflect the position of the Federal Housing Finance Agency staff on the particular issue, and will be followed by examination staff. Advisory Bulletins are effective upon issuance.

[FR Doc. 2012-24639 Filed 10/04/2012 at 8:45 am; Publication Date: 10/05/2012]